

November 4, 1981

LETTER 821

Oct. 23, DJIA 837.99; PTI 1380; A-D Ratio -23.88
Oct. 30, DJIA 852.55; PTI 1384; A-D Ratio -23.14

THE PICTURE: The "mild recession" that a few experts now recognize—is accelerating downward. The latest figures show that orders for non-military capital goods (the basic components for new plant and equipment) plunged 9.5 in October. Orders for household goods, such as appliances, dropped 4.7% while in transportation goods (automobiles and parts) new orders fell 7%. The shock of the past few weeks was GM's report that it had lost \$468 million in the third quarter and was calling off plans to construct a half billion dollar plant in Kansas. Chrysler, meanwhile, is rumored to be preparing to borrow the final \$300 million of its Government loan package. US car sales in October fell to a 23 year low as even rebates failed to turn the tide. At the same time, housing slumped into what many builders are now referring to as the "Second Great Depression." Machine tools (a barometer of potential industrial expansion) dropped 50% in September, the lowest level in five years. And on the fiscal front it was reported that interest expenses are now eating up 45% of corporate net profits before taxes, up from only 14% in the 1960's!

Many of the things I have been warning about (because of rising debt and over-spending) are now occurring, and I take little pleasure in my nightmares coming true. But my worst fear is that we will see a recession (depression) that could send corporate earnings into a tailspin. These collapsing earnings would be greatly intensified by the rocketing levels of short-term debt. Faced with towering debt servicing charges and slumping earnings, many corporations could become totally insolvent. In this kind of atmosphere, a grim procession of bankruptcies would be set off.

PRICE MOVEMENT: The last primary downswing ended on September 25 with the D-J Industrial Average at 824.01, the Transportation Average at 335.48 (see page 1 chart). At that

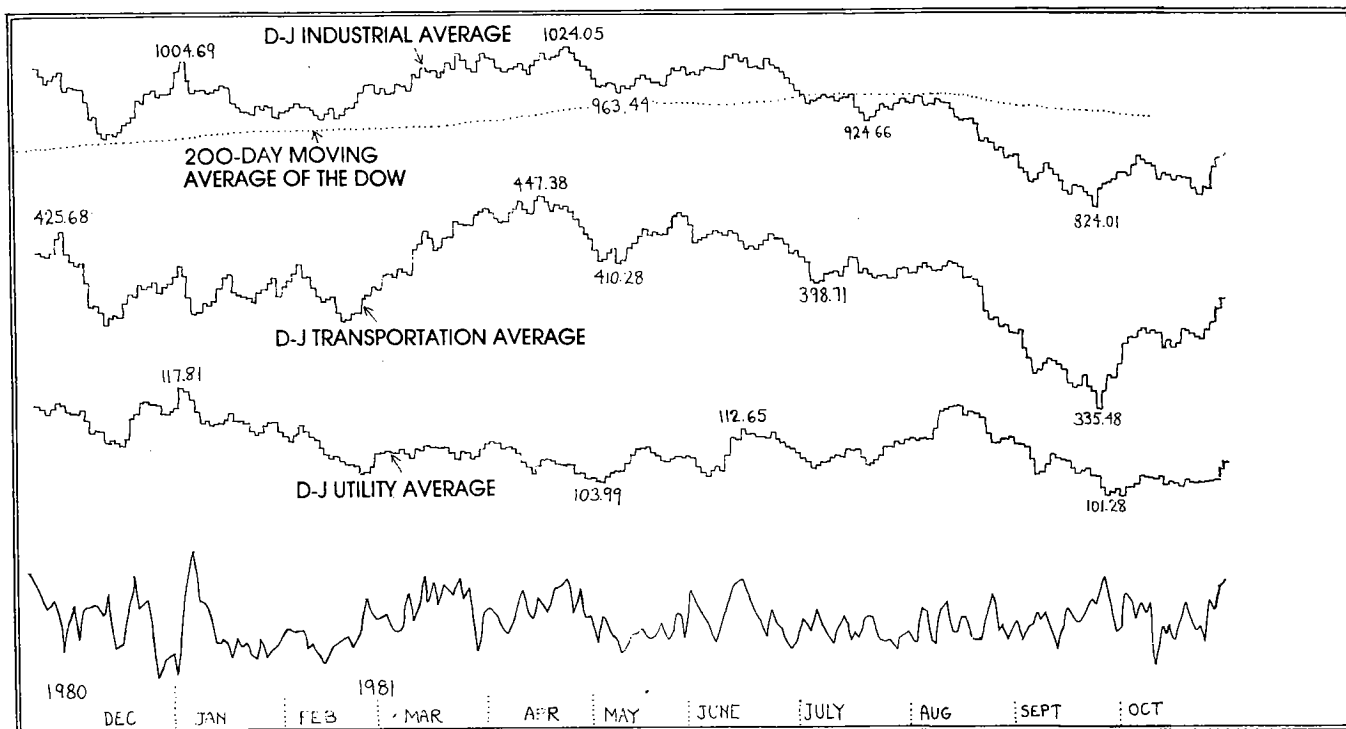
FRONT PAGE COMMENT: Make no mistake about it, despite anything you may have heard, the US budget is still OUT OF CONTROL. Ponder this: the Carter spending package for 1981 was \$611.5 billion. The Reagan spending package for 1982 (after supposed brutal cuts) is \$720 billion, more than \$100 billion over Carter's budget! On top of this (1) we are moving into recession, (2) Federal tax receipts are heading sharply down because of the recession, and (3) there is a big tax cut coming. This three-pronged phenomenon promises to send the 1982 Federal deficit near or over \$100 billion (particularly in the face of Congress' refusal to cut spending). As I see it, the trouble in the money markets is just heating up.

Social Security, a huge drain on the Government, is also running out-of-control, and the case for SS borrowing from Medicare is fast evaporating. Why? Because the latest figures show that all three of the system's funds, Medicare, retirement and disability will run out by 1988 and under "worst case" conditions by 1984.

The profligacy and spending mania of three generations of Americans is about to end in shambles. The Federal Government faces the worst financial mess in its history. And it's all been reflected in the 35-years of declining bond prices—with more to come!

point many analysts proclaimed a "major selling climax" and "an end to the bear market." I am not as optimistic. I see nothing in my work to indicate that the bear is dead.

In the last Letter I wrote that the majority of secondary (upward) corrections in bear markets tend to trace out complex patterns with usually two or more upward thrusts following the initial primary low. The first thrust in the current correction took In-



dustrials to 878.14. Transports to 373.07. Last week a second thrust took Transports above 373.07 but the Industrial Average was so weak that it barely edged off its lows. Whether this divergent action is enough to complete the (upward) corrective movement I cannot tell at this time. But flagrant divergences and non-confirmations following a rally in a bear market are never good signs. My expectations are for new lows in all the major Averages during November or December.

One characteristic of a primary bear market is that the bad news has not been discounted. Thus, when bad news on a stock surfaces, that stock will tumble in a bear market. An example is Revlon, which last week broke 6 points on a poor quarterly earnings report. Far more ominous (because the industry affects or employs 1 out of every 6 American workers) is the auto picture. On last week's shockingly bad earnings report, GM broke to 35, which put it within 6 points of its 1974 crash low. Ford is now at its lowest price since the 1960's, while Chrysler is selling at a price just this side of oblivion.

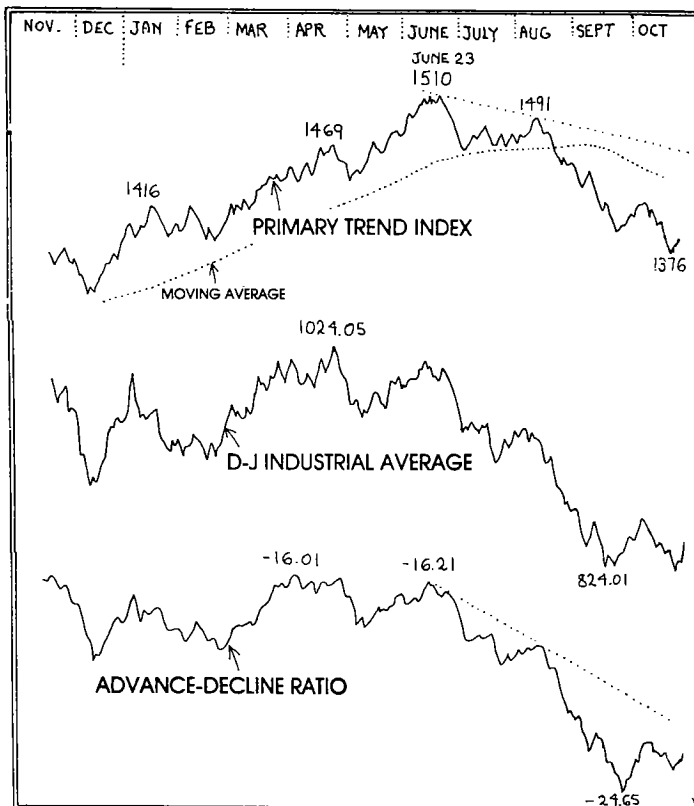
Comment: Last June Merrill Lynch in a full-page newspaper advertisement across the nation proclaimed "the dawn of a new bull market in bonds." Since then hundreds of millions of dollars have been lost in the bond market. But no words of regret from Merrill Lynch, no public apologies, no refunds, nothing. Everyone loves a bull, even if the bull is a fool. I didn't buy any bonds on Merrill Lynch's costly announcement, and I'm not ready to buy any bonds OR STOCKS now. Wall Street has no shame and it has very little conscience. Wall Street is a salesman and it's job is to distribute stocks and bonds. My job is to try to make people think, and to come up with observations and thoughts that (I hope) are helpful. Thought for this issue — **THEY NEVER RING THE BELL WHEN A BULL MARKET STARTS.** Merrill rang the bell.

PRIMARY TREND INDEX: For the benefit of new subscribers I will explain that the Primary Trend Index (PTI) is my own invention, an amalgam of eight critical averages and indices that are computed each day. The PTI measures the build-up or the deterioration in the technical condition of the market. The PTI is so constructed that a steady rise in the PTI is bound to send the broad market higher. Conversely, a steady decline in the PTI will inevitably press the market lower.

The PTI sometimes leads the averages, it is sometimes coincident and it can even lag. But a *persistent trend* in the PTI will always pressure the market in the direction of the PTI. As veteran subscribers know, the readings of the PTI have been of great use in our never-ending search to identify the underlying trend of the market.

Much has been written about Wall Street being "a market of stocks" rather than a stock market. But when the primary trend turns bullish, roughly 85% of all stocks will rise, and when the primary trend turns bearish 85% or more of all stocks will go down. Thus, if I were given my choice of good stock selection or good market trend analysis, I would invariably pick good market trend analysis. I say this because regardless of how well a corporation is doing, the overwhelming odds say that its stock will tend to follow the broad trend of the market. If you don't believe this, check the performance of any well managed mutual fund or pension fund over the past five months.

The PTI doesn't often form major recognizable top or bottom patterns. But recently, a fascinating picture has developed in the PTI. And I have been writing about that picture in recent Letters.



The last Letter, in fact, included a P&F chart of the PTI, and the large and ominous head-and-shoulders top was glaringly obvious.

In this Letter we will refer to the daily chart of the PTI. I keep a 3-week, and 8-week and a 21-week moving average of the PTI, and from now on the PTI chart will include the 21-week moving average. The position of the daily PTI above or below the 21-week moving average should help us in identifying the major trend of the PTI.

The PTI is now leading the Dow and the major stock averages on the downside, and on October 26 the PTI sank to a 1981 low of 1376. A continuation of the declining trend in the PTI will mean that the technical under-structure of the market is eroding. In this case, it will only be a matter of time before new lows are seen in all the popular averages and breadth measurements.

The advance-decline ratio is a proxy for ALL the stocks on the NYSE. At the bottom of the chart you will note that the A-D rallied about 2 points from its September 25 low, then dropped back a point. The showing here is lackluster so far. The market has simply bounced up from an over-sold condition.

INVESTMENT POSITION: I've often explained to individual investors that the best way to view your money is as your own ongoing business enterprise. Your money is, or should be, a vehicle that produces an income for you. If you are employed or if you own your own business, then your money should be considered a "second business."



Now when you own or run a business, you don't treat it like a traveling crap game. You treat it very seriously, and you do a lot of thinking before you buy inventory or take on expenses. You should treat your money (investments) the same way. I used to work for a shrewd millionaire who told me, "Russell, I only worry about the possible losses, the profitable items take care of themselves." And it's exactly the same in investing. I worry about

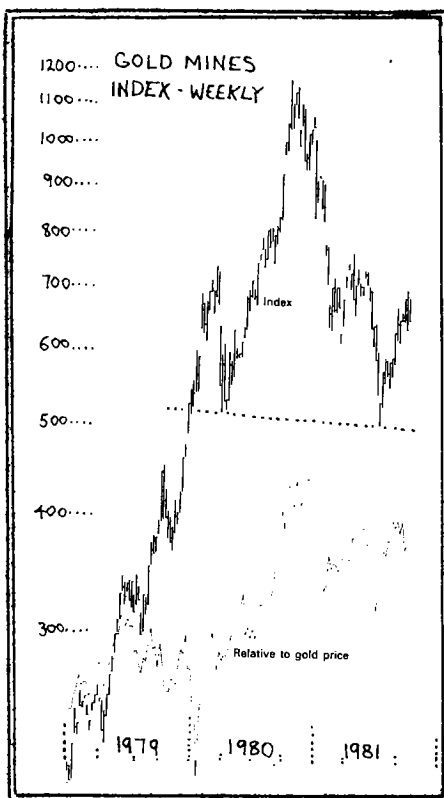
the potential mistakes in investing; the right moves take care of themselves.

One of the worst mistakes you can make in investing is to get chewed up in a primary bear market. I've explained over and over again how a bear market loves to lure you in, suck up your money (it plays on your greed), then take you on a sleigh ride down and finally dump you with losses. By the time you're finished trying to beat the bear with in-and-out trading, shorting, jumping in on hot tips and buying on some broker's advice, you might just as well take the night plane to Vegas. You'll have more fun there, and you'll waste less time and energy.

You have to understand that there are a number of types in this business who will (perhaps unconsciously) cost you money. There are (1) the brokers who have to sell stocks, make commissions, in order to survive. (2) The investment advisers who have to "do something," appear like geniuses in order (they think) to keep you following them. (3) The fund managers who believe they have to beat the averages or beat the other funds in order to justify their salaries.

Basically, what I'm trying to do in these Letters is teach people how to handle their money like a business. If you're in the chemical business and the price of the items you use are in a long slide, you don't load up unless you have good reason to believe you're near the bottom. Well, the same thing is true in the stock market. I don't think we're near the bottom of this bear market yet, so my advice is STAY in T-bills. Despite this advice, I get calls, letters and telegrams daily asking about whether it's time to buy GM, GE, Disney, potatoes, corn, muni's, Government bonds, a home in Palm Springs, you name it. My answer is that "We're in a bear market, stay in T-bills."

People complain, "But what can happen to a T-bill?" And I answer, "Nothing, and that's exactly the idea."



THOUGHTS ON WHAT LIES AHEAD:

As subscribers may have surmised, I do a lot of thinking about what may lie ahead. And (consciously or unconsciously) I always align my thinking to what is occurring in the charts. In other words, if I believe some phenomenon is about to develop but the charts provide no indication of that phenomenon — then I forget about it. My thesis is that the market can see farther ahead than any man or group of men, and if the market can't see it, it's not going to happen.

Question: All right, Russell, you've aroused our curiosity. Stop the banter, and let's get into what you see, or think you see, in the period ahead.

Answer: The first thing I want to talk about concerns this weekly chart of the Gold Mines Index put out by *Capital International Perspective* (3, Place des Bergues, CH 1201 Geneva, Switzerland). What I see here is a huge, potential "head-and-shoulders" top, a top that is capable of cutting the gold shares in half or more. And I ask myself, "What can this chart mean?"

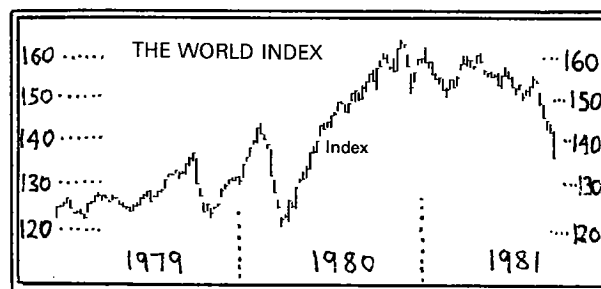
Question: And what does it mean?

Answer: My first reaction is that it means *deflation*. It means a lower price for gold bullion in the face of world business troubles. And that's frightening. My second reaction is that maybe the chart pertains only to South Africa and its gold shares. But this is far less likely, since (ironically) S. Africa is enjoying the strongest industrial (non-gold) stock market boom of any nation in the world. If there was going to be racial trouble in S. Africa, the industrial shares on the S. African exchange would reflect this. And they aren't. Therefore, this chart probably pertains to gold shares in general — and gold. And the chart is warning of world deflation.

All right, that's chart number one. The next chart (also from *CIP*) portrays the World Index, which is based on the market value of stocks in 18 leading Western countries.

This Index shows that world prices on average have been declining since late-1980 and that all gains going back to late-1979 have now been wiped out. Note also that the World Index has accelerated its decline with losses growing viciously during September. The Index has a distinct bear market look about it, and the decline is now almost one year old.

Question: Ok, Russell, the World Index is in a bear market. What are the implications?



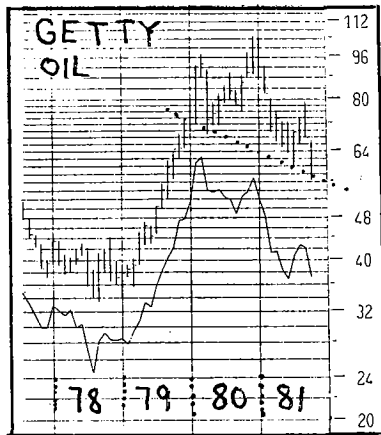
Answer: With the US in a bear market and the rest of the world in trouble and unable to take up the slack, we have a very serious situation confronting us. The world debt has rocketed practically beyond calculation, and on top of that we have a giant Euro-dollar market with no lender of last resort. My own thinking is that there is now a very large potential for world deflation.

Furthermore, I think that the huge top in the gold mining shares and the top in the World Index could be telling us the same story, and that story is coming world deflation.

You see, I believe that a whole new psychology and a whole new investment stance is moving into place. The new stance is going to be *liquidity* and *cash*. For decades now we've been hearing about the wonders of borrowing with current dollars and then paying off (if, indeed we ever do pay off) with cheap, inflated dollars. Suddenly, as the debt becomes exceedingly hard to handle, as

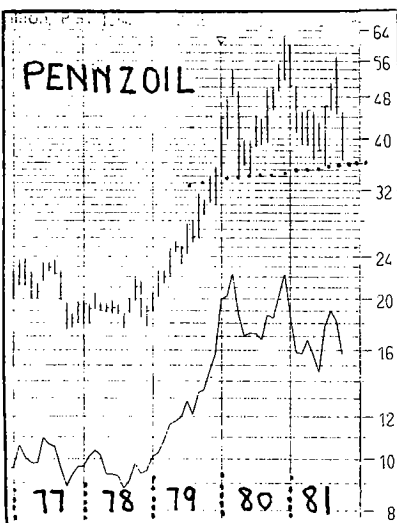
interest rates remain high, the borrowers realize that they have been sold a bill of goods — last year's goods. This year's story is that if you owe too much you are going to go broke, and the Government may not bail you out (the Government has its own troubles).

Thus, the new sentiment is save and collect the interest; the new investment posture is cash, and more cash.

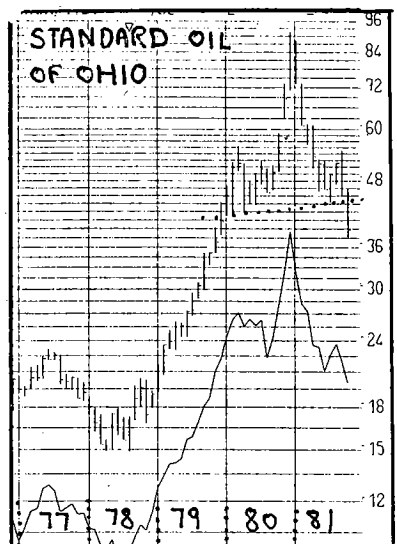


Question: You keep talking about the possibility of deflation, but I note oil prices are still holding in a high area.

Answer: Oil is still selling (OPEC) around \$34 a barrel, but these long-term (monthly) charts of major oil companies look ominous to me. An awful lot of the big oil stocks are now in major distribution patterns, patterns so extended that they can only be comprehended on the monthly charts. Here are charts of Standard of Ohio, Pennzoil and Getty — all in massive head-and-shoulders TOPS. My conclusion here is that we could be near a break in oil prices. Certainly, these charts are telling us that some kind of trouble lies ahead for the oil industry.



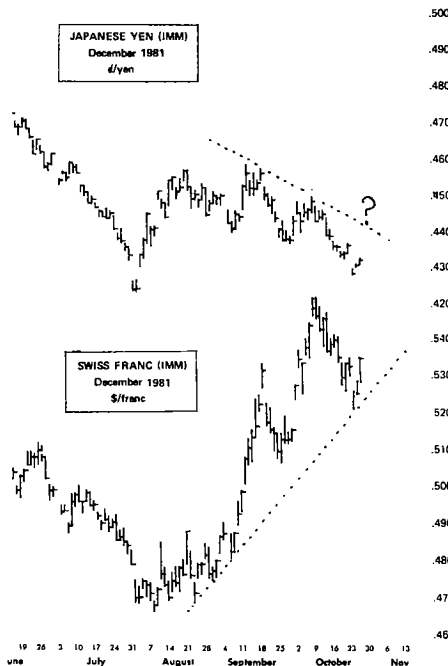
Question: What else have you got for us Russell?



Answer: I've got a real mystery, and it's called the Japanese yen. I show here a chart of the Swiss franc and the yen (charts courtesy of *Dunn & Hargitt*, 22 N. 2nd St., Lafayette, IN 47902). I show the franc because it is typical of the recent rallies in most currencies against the dollar. Between July and early-October the major currencies, the franc, the mark, the pound, the Canadian dollar, they all popped up (in bear market rallies) against the dollar — all that is, except the yen.

So I ask myself, "What's wrong?" And I note that the trade situation between the US and Japan is becoming a terrible problem for the US. The problem: Japan is beating our brains out with a \$14

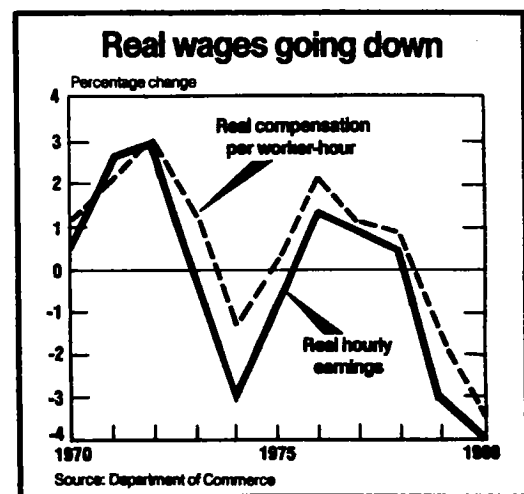
billion surplus this year in favor of Japan. In many areas Japan is far out-producing us, and Japan's trade target areas are expanding (the next target for Japan is pharmaceuticals). Even more threatening, Japan is now moving from pure production into advanced technical research. And they're good at it!



What happens next (even as the US slides into recession)? My guess is that trade barriers and protective quotas are what happens next. If so, Japanese exports will be hit, the yen will turn weak (which it already has). Thus, I see today's weak yen as a sign of economic trouble, vicious trade competition, and a coming defensiveness on the part of the US. The defensiveness, by the way, will intensify as unemployment in the US climbs over 8%.

Question: What next, Russell?

Answer: The final chart shows real (minus inflation) wages in the US. Most people don't realize it, but real wages topped out in the early 1970's, they slumped into 1974, rallied in 1975 and are now at a *new low*. The fact is that the average American wage earner is doing worse now in terms of what he can keep than at any time in the last decade. Now the one item that has held up



this year is consumer spending. The American consumer is still spending his head off. Either he hopes the whole economic mess is just a fantasy, or he doesn't give a damn. But this chart tells me that the consumer is shortly going to HAVE TO cut back on his spending. He simply doesn't have the money, and it's getting awfully expensive to borrow it. When that happens, when the consumer cuts back, the recession will be on in earnest.

Question: What do you think is the major factor in the consumer picture?

Answer: I see two critical factors now. The first is unemployment. Rising unemployment scares the consumer, and if unemployment pushes over 8% the consumer is going to get scared. The second big factor is housing prices. Housing is the most inflated single item on the American landscape (I say this because you buy a house for \$200,000, it costs you \$36,000 to carry, yet you can't rent that same house for even \$15,000 a year).

If the price of housing busts, really breaks down, the nation is going into depression. The wealth of America is now largely tied up in real estate and housing. This is where the average citizen has his "savings." If home prices break by say 40 to 50%, then we have major trouble. So this is the area that I'm watching carefully. So far, home prices have given some, maybe 10% to 20% in certain areas, but there's been no real bust yet.

NOTES & QUOTES: Men like to believe that "women are the weaker sex," but you can't prove it from the longevity statistics. For instance, 60% of all people in the US over 65 are women. And 65% of all people in the US over 70 are women. Men may run America, but the way things are going women are going to own it. But if you work for the Washington Post or the San Diego Union or the Los Angeles Rams you already know that.

Partly due to the narcotics invasion, Florida and more particularly Miami has become the crime capital of the US. Miami Beach is no longer "fun and sun" city, I'm told, it's "slum and bum" city. Florida now possesses 7 out of the 10 worst urban crime rates in the nation — from Miami to Gainesville to Tallahassee. Gun dealers in Florida report gun sales are up 46% over last year (and most of these guns are sold to citizens — for self-protection). Sun belt anyone?

APOLOGIES: I have a small group of subscribers who are perfectionists. They scrutinize each Letter for typos and errors — and I soon hear about it. Now I hate to frustrate any group of subscribers, and for this reason you will notice that every issue of Dow Theory Letters contains a typo, a statistical error or a new exotic type of mistake. Letter 820 was no exception. On page 1, last paragraph, it should read "Note that following the peak of 1015" rather than "peak of 1510." If you were confused, I apologize.

From our "Signs of the Times" Dept:

Schools Broke

DETROIT — Not since the Great Depression had a Michigan public school district been forced to close for lack of money.

But suddenly this week, one district is closed, another is scheduled to shut its doors, a third may go broke before the end of December and three others are perilously close to financial collapse, says state schools Superintendent Phil Runkel.

The problems facing Michigan schools are compounded by a financially devastated state government which is unable to bail them out.

The battle of the budget goes on. The latest is an increasing string of hints to the effect that the budget picture remains a disaster. The Senate Budget Committee now states that without changes the budget deficits will be \$66 billion in 1982, \$81 billion in 1983 and \$90 billion in 1984. Adding another quarter trillion dollars in deficits to the budget over the next three years would be fiscal insanity — but it could happen. The cuts needed (in view of rising military expenditures) will have to be massive, and new taxes will be needed as well.

Meanwhile, these figures from the Tax Foundation show that government spending at all levels is now consuming about one-third of the total American GNP. On the financing front, late statistics from Morgan Guaranty show that financing of the Federal deficits now sops up 40% of all U.S. savings. Add to Morgan's figures the city, state and county financing needs, and you can see that government in all forms is now swallowing up most of the supply of new money. All this can only end up in an interest rate spike—as the supply of available new funds dries up.

YEAR	G.N.P.	TOTAL GOVERNMENT EXPENDITURES	PERCENT OF G.N.P.
1930	\$ 90.7	\$ 11.1	12.2
1940	100.0	18.4	18.4
1950	286.2	61.0	21.3
1960	506.0	136.4	27.0
1970	982.4	311.9	31.7
1975	1,528.8	532.8	34.8
1978	2,106.6	684.2	32.5

The General Accounting Office accuses the Pentagon of poor financial planning. Why? The wild cost "over-runs." Contractors bid too low on weapon systems. Then when they get the contracts (after a year or two lapse) the real costs are revealed. Of course, inflation is also blamed. Two examples: The cost of the Army's new M-1 tank has climbed 76% in the last year. The cost of the Navy's F/A-18 fighter rose 43% in the last year.

Even the London *Economist* is becoming worried about the world debt balloon. This piece from the Oct. 9 *Economist* was, I thought, well worth including in this section:

The overborrowers

Although investors have not overborrowed to keep stock markets too high as they did in 1929, many other groups have overborrowed in 1981 to do many other things. The overborrowers include homeowners and property men everywhere, holders of many glutted and stockpiled raw materials, bankrupt private companies which cannot afford to meet obligatory redundancy payments, nationalised corporations with a dozen successive years of negative cash flow, governments with estimates for small budget deficits that are obvious fibs, countries like freedom-seeking Poland and growing Brazil and starving Bangladesh.

If this overborrowing were ever punctured, there could be crashes in property prices from California to Hongkong, in companies from Detroit to Seoul, in state corporations from Milan to the North Sea, in overstocked materials from Oregon timber to Nigerian oil, in government credit from Washington to Tokyo, in banks and near-banks from Switzerland to Singapore, in financial consortia and their clients everywhere. The downward multiplier from all that could make 1929's

little local stock market difficulties look like a controlled parachute drop.

As money grows dearer round the world, some of these overborrowers are overborrowing more so as to meet their higher interest payments. They are increasing their indebtedness to pay for their debt. This must make punctures more possible. That is why it is so wrong to be meeting and aggravating slumpflation by ever higher interest rates, so awful that overborrowing governments are borrowing more instead of cutting the money wages of their employees, so bumbling that central banks are bidding fixed-interest rates higher instead of borrowing on the index-linked securities that would be cheaper at this time, so frightening that even very conservative governments are cutting taxes and pretending that these will be covered by expenditure cuts that will not actually come into effect.

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Jim Fraser (Fraser Management Assoc. Inc.; Box 494, Burlington, VT 05402) writes me that he has reprinted my 1961 book, *The Dow Theory Today*. This is a collection of twelve articles which I wrote for Barron's between 1958 and 1960. Jim states that this is a limited printing, and that he will accept orders from my subscribers for the soft-cover book at a special price of \$5. The book may never be offered again. I have received many requests for it (I sold my last copy 10 years ago), and I believe this volume will be of real interest to all market students. Write Jim for the book, not me (I don't make a cent on the sales).

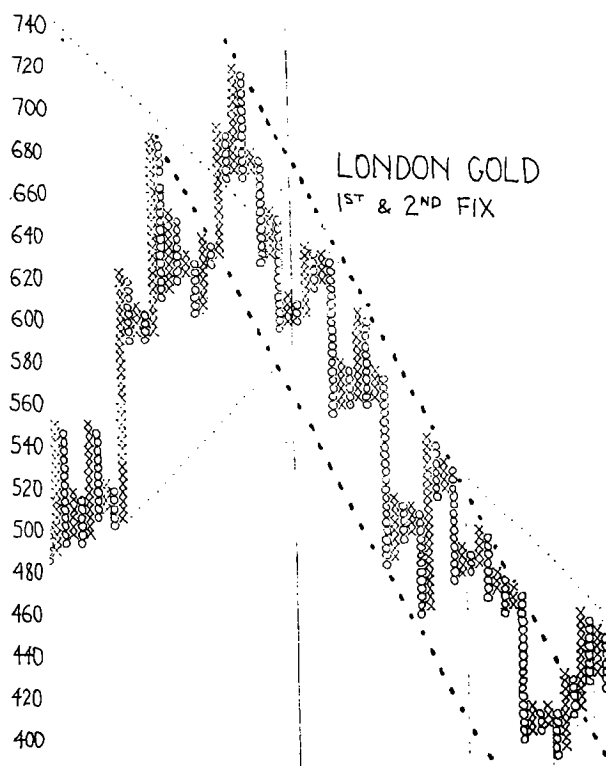
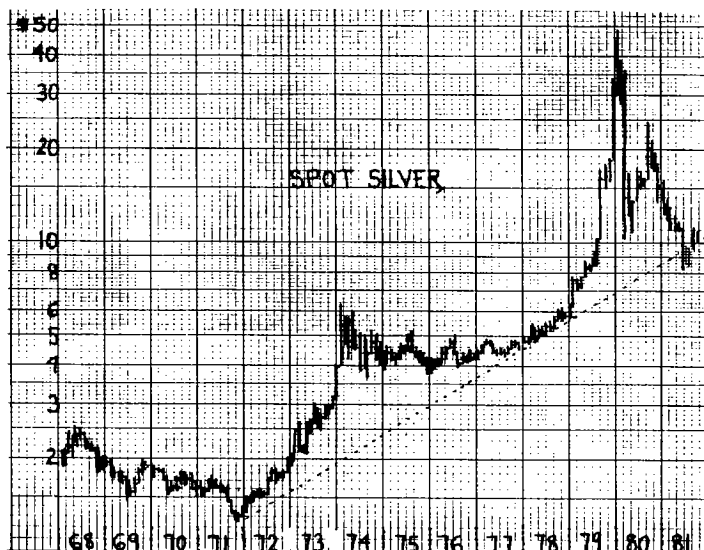
GOLD SILVER: There's one major difference in the technical situation between gold and silver. Gold is still holding above its major trendline from the 1971 low. Silver, as you can see on this semi-log chart, cracked its trendline this year — when it broke under 9. For this reason, I see the technical position of gold as stronger than silver.

On the point & figure chart we see gold still holding above its long downward channel line, and as long as this is true the secondary trend of gold is bullish. Note on the chart that at 424 spot gold set off a minor bearish signal in that it broke below the last column of zero's. On a P&F basis, gold must hold above 408 if it is to remain bullish in a secondary sense.

On my exponential moving averages, the 5-week MA for gold is 434, the 13-week MA is 435, and both of these MA's are moving roughly sideways BELOW the 50-week MA which is now at 475. Spot gold is now below all three moving averages — but there doesn't seem to be much momentum in gold either way. In my opinion, the great unconscious of gold is waiting to see what happens as the recession drags on. If the Administration decides to monetize the federal deficits gold will take off on the upside. If the Administration finances the deficits via the money markets (deflationary) gold will sag. No Administration has been ready to take recession and deflation — yet.

FOR NEW YORK SUBSCRIBERS: In accordance with the New York Investment Advisers Act, we have filed our Investment Advisor Statement and New York subscribers may obtain a copy of it upon request. A fee of \$14 will be charged for xerox costs.

NEXT MAILING: NOV. 18



LATE NOTES: In the face of (1) a deepening recession, and (2) the need to finance about \$65 billion in new money over the next 6 months, Washington officially threw in the sponge. On October 30 all talk of "holding the line" was forgotten as the Fed lowered the discount rate a full 1% to 13%. A few of us remembered President Reagan's stirring words, "If not now—when. If not us—who?" With the Fed's action, Reagan's words faded out like a tired echo.

On the news of the drop in the discount rate, the markets popped as stock and bond buyers rushed in. With this new stimulation the stock market may now be ready to round out the secondary (upward) correction with an assault on the October 8 highs. Again I want to repeat that bear market rallies are tricky and deceptive. The bear wants to take this market down with a full crowd aboard, and that takes time. It's a truism that a bull market likes to rise with as few followers as possible and a bear market likes to decline with as many followers as possible. And that's why Wall Street is structured to part you from your money.